A

STATEMENT ON

FEDERAL CIVILIAN RETIREMENT PROGRAM DESIGN

by

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before the

House Post Office and Civil Service Committee

March 28, 1984

*The views in this statement are those of the author and do not necessarily reflect the views of The Wyatt Company or any of its other associates or employees.

Mr. Chairman, I am pleased to appear before the House Post Office and Civil Service Committee to present some background information that might be helpful in your consideration of a federal civilian retirement program to be coordinated with Social Security. I am the Director of the Research and Information Center for The Wyatt Company, an actuarial and consulting firm that specializes in the design and analysis of pension plans and other employee benefit and compensation programs. Earlier in my career I served as Deputy Research Director of the Congressionally mandated Universal Social Security Coverage Study and, in that role, I spent a considerable amount of time evaluating ways the federal civilian retirement program could be coordinated with Social Security. My comments today are my own and should not be construed as representing the position of The Wyatt Company or any of its other employees.

Rather than trying to sketch out any specific retirement proposals or plan designs that you may wish to consider I want to focus today on the standard retirement plan designs that prevail in the private sector. I have attached to my testimony a paper I did during February 1983 for the Society of Government Economists. This paper addresses some broad conceptual issues you will have to consider in selecting a general approach to plan design when you finally take up the task in earnest. I did this paper while I was Research Director at the Employee Benefit Research Institute.

In the current discussion I am going to restrict my analysis of existing private retirement policy to large plans. I realize some analysts argue that the federal retirement system should be designed in consideration of all retirement systems, not just those sponsored by large employers. My impression is this position is motivated by the perception that small employer pension plans are not as generous as larger plans. If that is the case it is certainly not reflected in the funding data in table 1.

Table 1

PENSION COSTS AS A PERCENT OF WAGES AND SALARIES
BY PLAN SIZE

Number of Participants	Pension Contributions as a Percentage of Labor Costs
1-10	37
11-25	14
26-100	12
101-500	7
Fortune 500 firms	7

SOURCES: _Fortune 500_ data from Johnson and Higgins; data for small plans from American Society of Pension Actuaries, "Analysis of Characteristics of Small and Medium Size Employer Sponsored Private Retirement Plans," in a Report to the President's Commission on Pension Policy, 1980. These data were cited in Sophie M. Korczyk _Retirement Income Opportunities in an Aging America: Pensions and the Economy_, (1982) p. 28.

The whole question of whether small plans are more or less generous and whether they should be included in comparisons with federal retirement plans misses the point. If the goal is simply to minimize federal retirement generosity, then all federal retirement programs should be eliminated. But that is not a realistic or socially desirable goal. It is not even a goal of the most vocal critics of federal pensions. A more rational approach is to recognize the federal government's position and competition in the overall U.S. labor market. If the federal government is to heavily skew its wage compensation or retirement benefit programs against prevailing market practices it is going to affect the hiring and retention of an adequate workforce to perform its mission.

Private Sector Retirement Provisions

The Wyatt Company annually conducts two surveys that are widely used to help design and modify ongoing retirement plans throughout the private

sector. The first is a detailed survey and analysis of the salaried pension, thrift/savings and profit-sharing plans in 50 of the largest U.S. industrial companies as determined from Fortune list published each year. The Wyatt Company has been doing the Top 50 Survey since 1968.

The Top 50 Survey deals primarily with pension plans covering U.S. salaried employees. The survey includes illustrative retirement benefits which reflect benefits payable to employees retiring currently under the companies' qualified pension plans. In addition, benefits for hypothetical future retirees are estimated. The survey also includes a list of other plans which are complimentary to the pension plans offered by the participating companies. The provisions of the thrift/savings and profit-sharing plans are outlined.

The second survey that The Wyatt Company has conducted each year since 1967 is a Survey of Actuarial Assumptions and Funding. This survey includes a sample of pension plans covering 1,000 or more active participants. In the 1983 survey, 727 plans participated. While most of these plans are smaller than those covered in the Top 50 Survey, there is some overlap in the two studies. The Actuarial Assumption Survey provides a broader sample for evaluating certain plan characteristics than the Top 50.

Both of these surveys include substantial detail that you may wish to consider in your deliberations over a retirement program designed for federal civilian workers hired after January 1, 1984. While neither of the most recent surveys reports has yet been published I would be glad to make them available to the Committee when they are. Both should be published within the coming month. In the remainder of this section of my testimony I will attempt to summarize some of the details from these two surveys that I think you might find pertinent.

Types of Plans. New plans being established today in the private sector tend to be predominantly defined contribution plans.[1] Under these plans the employer makes a contribution to a fund in behalf of an employee. Those contributions and accumulated interest can either be taken as a cash distribution on employment termination or can be converted into an annuity at retirement. While defined contribution plans may be most prevalent, about 70 to 75 percent of all private sector pension plan participants are covered by defined benefit plans. Under a defined benefit plan the employer promises the worker a specific benefit at retirement. The level of the benefit is usually related to length of service and earnings level.

Among the largest 55 industrial firms that we have surveyed this year for the development of the Top 50 Survey only two of the firms had a defined contribution plan as their primary retirement program. Of the 50 large firms with defined benefit plans included in the survey, however, all also offer defined contribution plans which can be considered complementary to the benefits provided by their basic plan. In fact, in 39 of the firms, more than one supplemental plan is offered.

The most prevalent supplemental plan among the Top 50 participants is a thrift/savings plan. These plans typically allow employees to save up to 6 percent of their salary which is then matched by the employer. While several large employers match the employees' contributions dollar for dollar, a 1977 Bankers Trust Study of thrift/savings plans suggests that the most common employer matching rate is 50 percent. Over the last couple of years many

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[1]This is a relatively recent phenomenon. Prior to the passage of ERISA the number of newly established defined benefit plans consistently exceeded the creation of defined contribution plans. For a detailed discussion of this phenomenon see Sylvester J. Schieber, "Providing Income Security to the Elderly: The Role of Programs Other than Social Security," in Contemporary Policy Issues, (Number 3, April 1983) pp. 33-52.

employers have modified their thrift/savings plans to include 401(k) income deferral provisions. While the employer does not match the portion of the worker's compensation that is deferred in this instance, there is a clear tax incentive that encourages participation. Of the 39 employers with thrift/saving plans in the Top 50 Survey, 26 companies include 401(k) provisions. Thirty-seven of the companies offer stock ownership plans. Six companies sponsor profit-sharing plans. Five of the six profit-sharing plans permit employee contributions, and three include 401(k) provisions in the profit-sharing program.

Employee Contributions. The above discussion implies that the supplemental plans prevalent in the private sector are largely a cooperative retirement saving effort by the employer and employee. In the thrift/savings plan, the employee must typically contribute to get the employer match. Through the profit-sharing plan, employees are encouraged to be industrious so there will be profits to be shared. Even the stock ownership plans are structured to bring the employee into a position of sharing in the corporate fate. While the thrift/savings or 401(k) options may be relevant for your considerations, it is unlikely that either the stock ownership or profit-sharing plans bear much relevance in this instance.

The primary pension plans sponsored by large employers are much less likely to require employee contributions than their secondary plans. In the 1984 Top 50 Survey, 39 of the plans have no employee contributions. One company allows voluntary employee contributions but these are not subsidized. Of the ten plans requiring employee contributions, seven have integrated their contribution schedules with Social Security. The typical contribution rate in the integrated plans ranges from 2.5 to 3.5 percent on earnings above $12,000 to

$15,000. In the plans requiring contributions that are not integrated the contribution rates are 2 percent of salary or less. Thus it is clear that in most cases private sector workers do not have to contribute to their primary pension plan, and where they do, the contributions are seldom more than a couple percent of salary.

Vesting. The one area in which the current Federal Retirement program is clearly inferior to private sector plans is in its vesting provisions. In fact, the Federal Civil Service Retirement System would be in violation of the ERISA vesting standards applied to private plans. Under ERISA a vested benefit is a commitment that must ultimately be paid in one form or other. A private sector pension plan sponsor can make provisions for cashing out the vested benefits for workers who have terminated employment prior to retirement eligibility. Alternatively the plan can defer benefit payments until the retirement eligibility criteria are met. In the case of the private plan, however, the withdrawal of any employee contributions to the plan would not lessen the plan sponsor's obligation to pay vested accrued benefits under the employer's segment of the plan. In the case of terminating federal workers who withdraw their own contributions after the five year vesting standard is met, the Federal Government's obligation to pay the vested benefit is liquidated by the employee's withdrawal. Such practice would be a violation of ERISA statutes for a private plan.

On the surface, private sector vesting practice may appear to be more harsh than the current five-year vesting provisions that are part of the Civil Service Retirement System (CSRS). Forty of the Top 50 Survey plans provide for full vesting after ten years of service. Six additional plans also have ten year vesting in combination with an alternative vesting schedule for special

cases (e.g., full immediate vesting for workers attaining age 55 if the other standard has not been met). Four plans include a graded vesting schedule that begins prior to ten years of service. Thus the prevalent vesting practice in large private retirement programs may be somewhat more stringent than the federal civilian retirement program in their tenure requirements, but vesting is significantly more meaningful in the private plans. Since as many as 80 percent of all vested federal workers who terminate employment prior to retirement eligibility withdraw their own contributions from the CSRS, vesting is almost meaningless in the current federal program.

Retirement Provisions. One area where the CSRS has been criticized is in the provision of unreduced retirement benefits at a relatively early age. For example, a full benefit is paid to workers attaining age 55 with 30 years of service under the civil service program. The criticism of this provision often focuses on the unavailability of unreduced Social Security benefits prior to age 65. While the CSRS retirement provisions are more generous than Social Security's, large private pension programs also frequently treat early retirement more generously than does Social Security in terms of early retirement benefit reductions.

Among the plans participating in the Wyatt 1984 Top 50 Survey, all but three plans provide unreduced benefits under some circumstances at age 62. Every one of the plans permits retirement by age 60, with 26 plans providing for unreduced benefits under certain circumstances by that age. Retirement at age 55 is not available under four of the plans in any circumstances. Thirty-five additional plans provide reduced benefits for workers retiring at age 55. The remaining eleven plans provide unreduced benefits but only in certain instances (e.g., age plus service equal to 80).

Similar information was gathered on a much larger and more diversified sample of plans in Wyatt's 1983 Actuarial Assumptions Survey. The results based on the characteristics of the 727 plans surveyed are shown in figure 1. In this case, 50 percent of the plans do not pay full benefits prior to age 65. Only 18 percent of the plans provide unreduced benefits prior to age 60. While 64 percent of the plans provide full or subsidized retirement benefits prior to age 65, less than one-fifth of the plans in this sample provide unreduced benefits at age 55 in any event. Similarly only 22 percent of the Top 50 plans provide unreduced benefits as early as age 55 and only 14 percent pay an unreduced benefit at age 55 with 30 years of service.

Benefit Levels. Pension benefits are often examined in terms of the portion of pre-retirement earnings that they replace. In this fashion the relative generosity of plans can be compared for individuals with similar work tenures and salary histories. For purposes of developing such benefit comparisons in the Top 50 Survey a salary of $35,000 was assumed for 1983. The historical pay schedule for purposes of benefit determination were based on the assumption that the person's pay had increased at the rate of the national average, plus 1 percent. The final salary assumed here is roughly comparable to that of a General Schedule Grade 12, Step 5 or 6. Choosing a higher or lower earnings profile might affect benefits marginally but would not radically change any conclusions that might be drawn from this analysis.

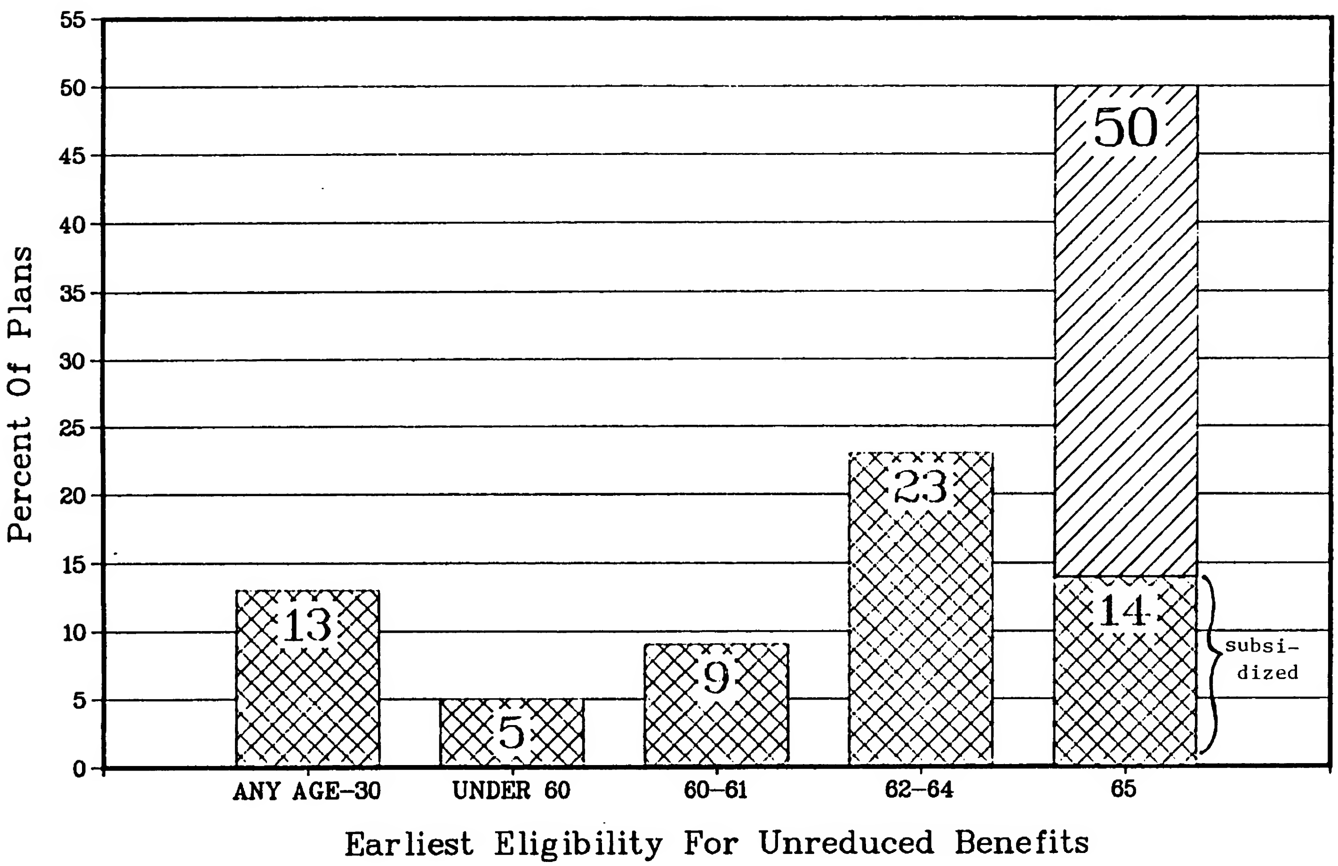
Given the diversity of age and service combinations that precede retirements under any pension plan, a large number of plan comparisons could be developed. To simplify matters, only three are presented here.

The first comparison considers a hypothetical worker retiring with 35 years of service at age 65. This long-tenured, late retiree's benefits were estimated under the current benefit formula for each of the plans included in

Figure 1

EARLY RETIREMENT BENEFITS

IN WYATT 1983 ACTUARIAL ASSUMPTION SURVEY



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Wyatt's Top 50 Survey. The results are shown in figure 2. The top graph in the figure shows the portion of the last year's gross earnings replaced by the pension plan alone. The bottom graph shows the combined pension and Social Security replacement of pre-retirement earnings. It is significant to note that the CSRS would replace about 62 percent of this person's pre-retirement earnings. On the basis of initial benefits alone, the CSRS benefit would not appear overly generous in comparison to large private plans for a full career worker retiring at age 65.

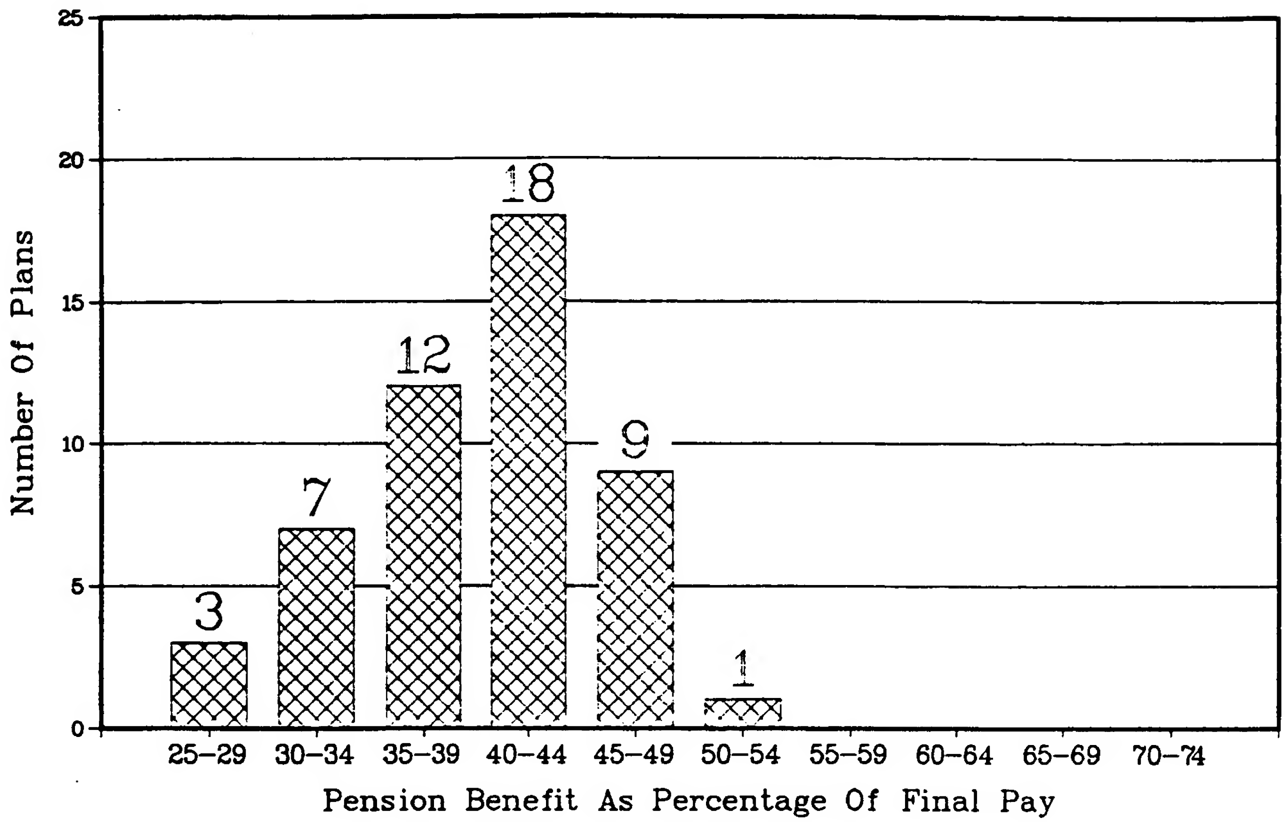
The second comparison considers a hypothetical worker retiring with 15 years of service at age 65. This short-tenured, late retiree's benefits were also estimated for each of the Top 50 plans and the CSRS. The results are shown in figure 3. The CSRS would replace 24.5 percent of the person's pre-retirement earnings, placing him or her toward the top of the pension replacement ranking alone, but at the bottom if both the pension and Social Security is considered. It should be kept in mind, however, that anyone with this age-tenure combination did not enter the employ of the final employer until age 50. Stated alternatively, such a CSRS retiree could have had up to 30 years of Social Security coverage in other career jobs. If that was the case with the CSRS retiree, he or she would undoubtedly have a relatively full Social Security benefit to complement the CSRS pension.

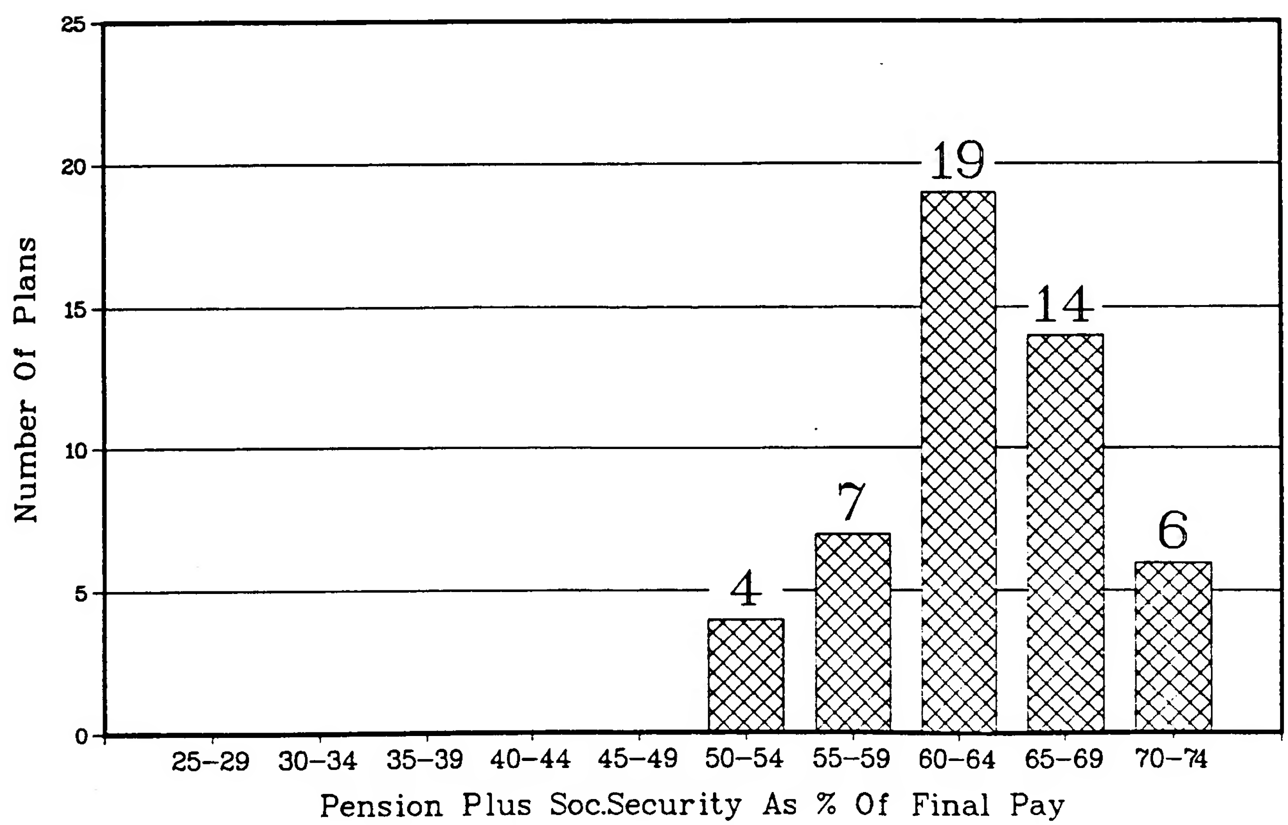
The third comparison considers a hypothetical worker retiring with 30 years of service at age 55. This person's benefit comparisons under the various Top 50 plans are shown in figure 4. The benefits shown here include all early retirement subsidies and supplementation available under the various plans. The CSRS would replace 52 percent of the last year's earnings, placing the federal plan significantly above any of the others included here.

Figure 2

CURRENT RETIREMENT

AGE 65 WITH 35 YEARS OF SERVICE



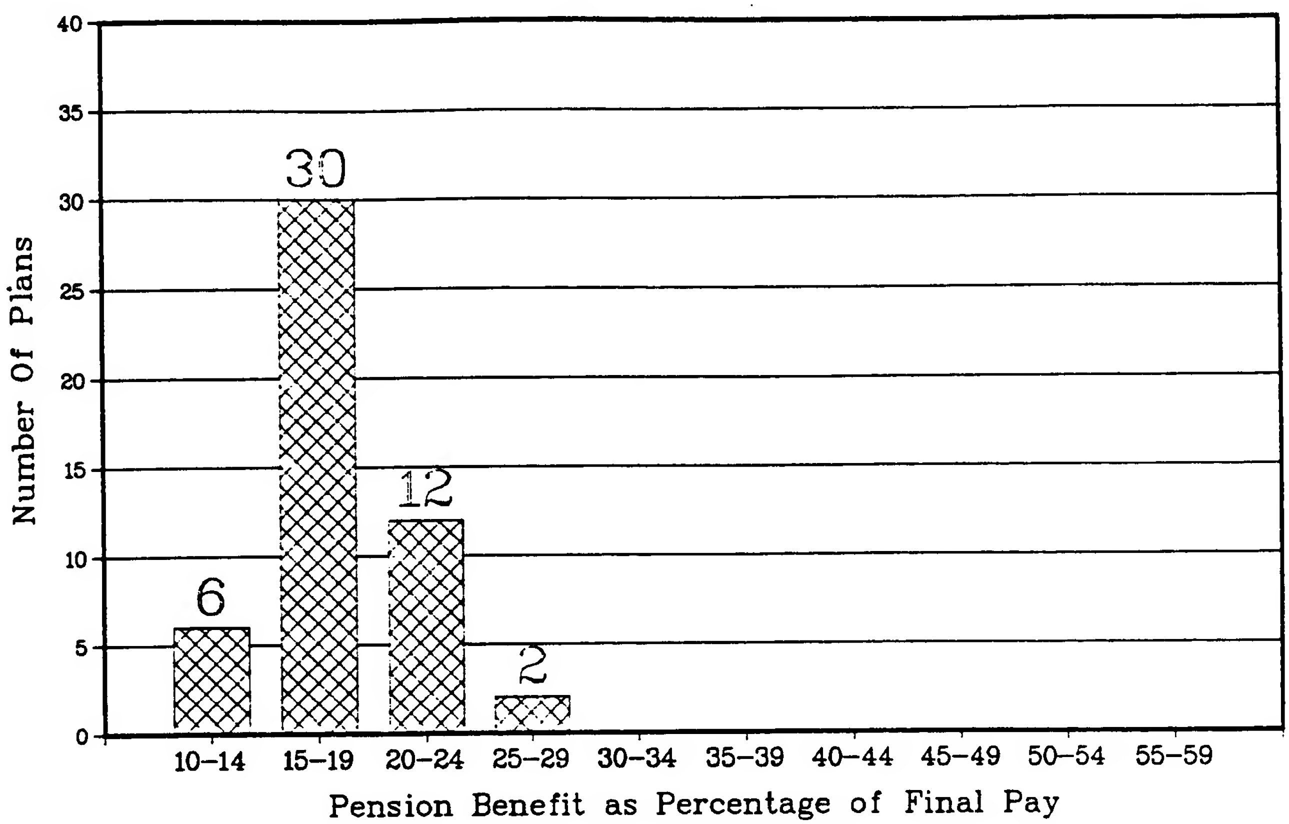


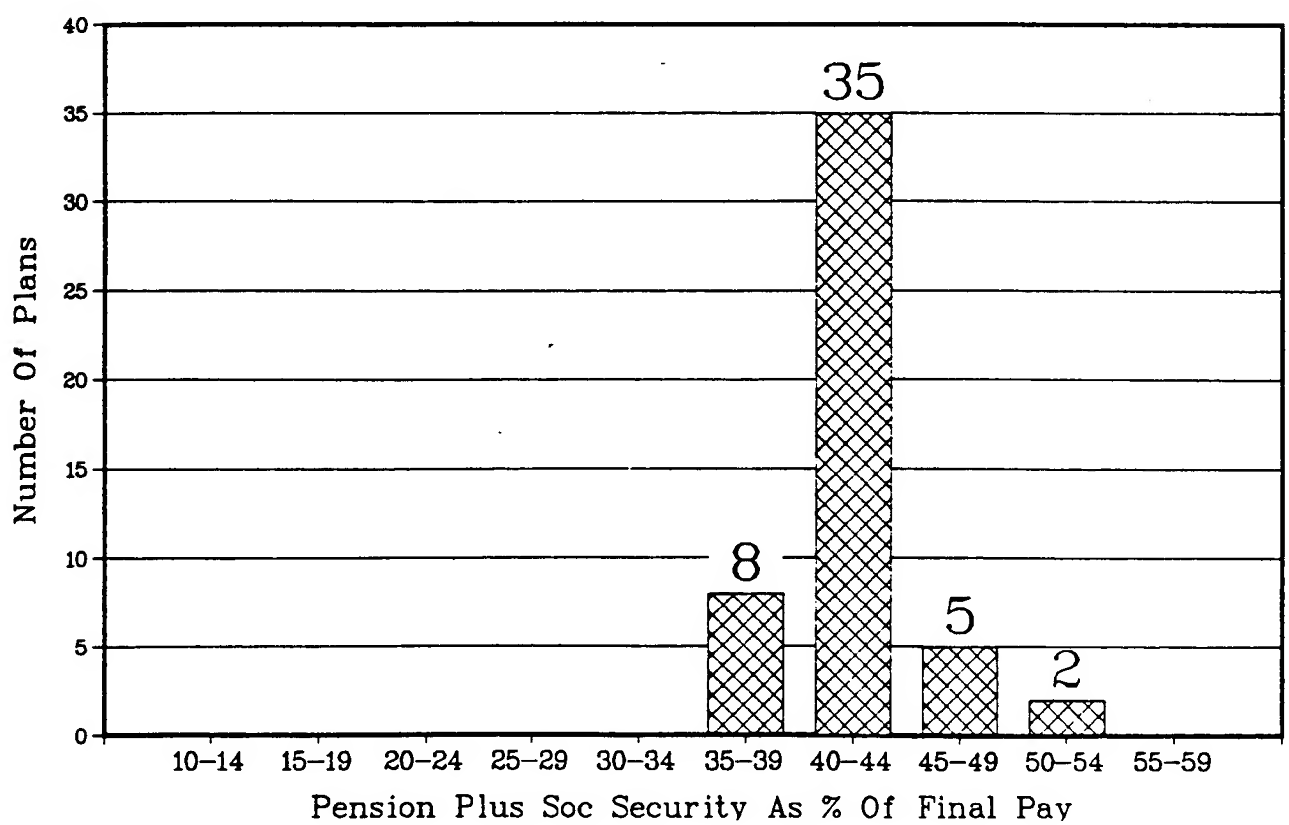
Source: The Wyatt Company, Top 50 (Wash., D.C., 1984).

Figure 3

CURRENT RETIREMENT

AGE 65 WITH 15 YEARS OF SERVICE

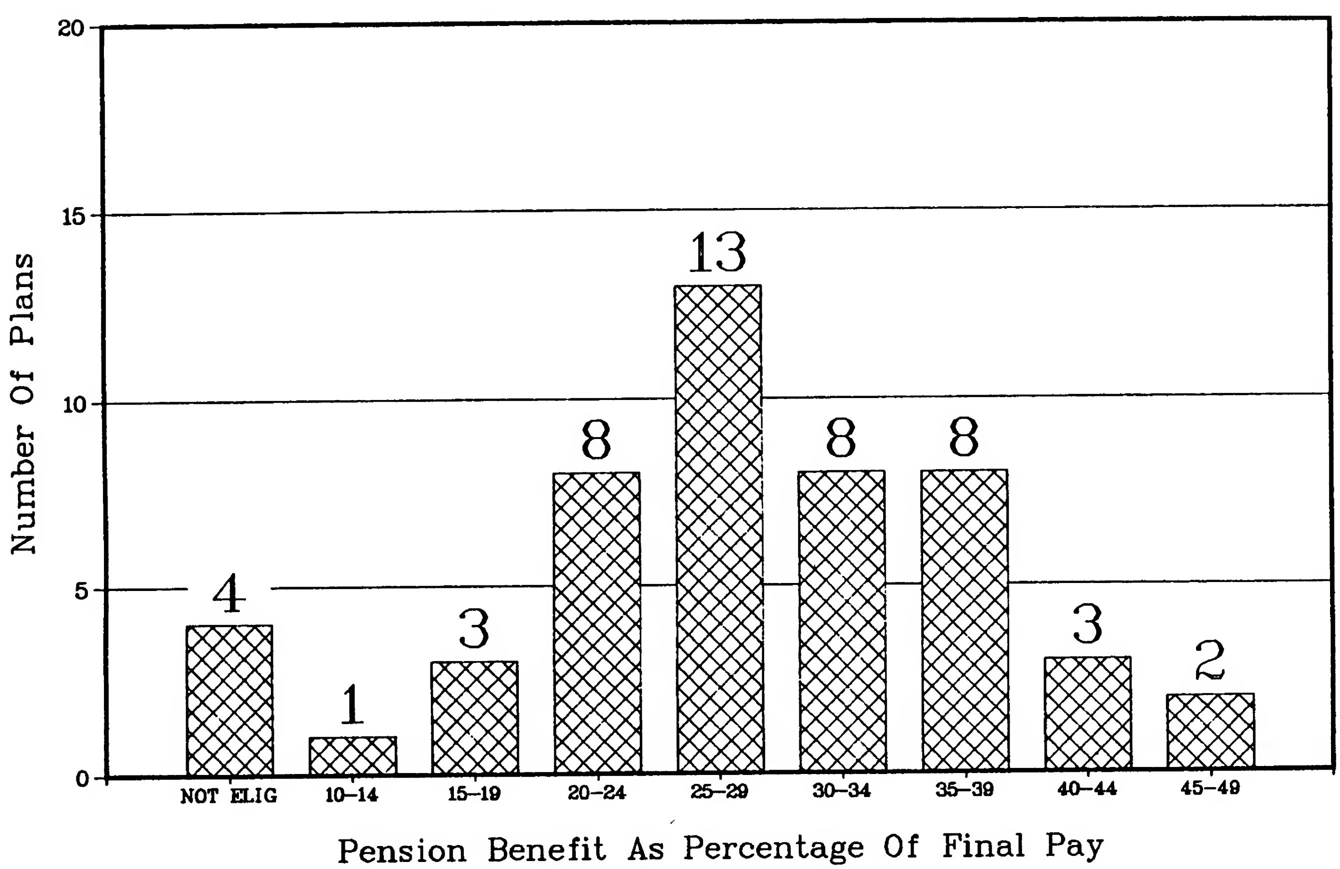




Source: The Wyatt Company, Top 50 (Wash., D.C., 1984).

EARLY RETIREMENT

IMMEDIATE BENEFIT AT AGE 55 WITH 30 YEARS OF SERVICE



Source: The Wyatt Company, Top 50 (Wash., D.C., 1984).

The benefit comparisons above suggest that the existing CSRS initial benefit structure relative to prevailing practice among large private-sector employers is: (1) roughly in line for long-tenured late retirees; (2) possibly a bit low, but indeterminant for short-tenured late retirees; and (3) clearly more generous for early retirees. Focusing on initial benefits, however, gives an incomplete picture of the true comparability of benefits provided by the various programs. When an individual retires, on average, they can expect to live and receive benefits for several years, even as many as twenty or thirty years or more. The relative generosity of plans, then, must be judged on the basis of benefits paid over the full period of retirement. This means that post-retirement benefit increases must also be considered.

Private-sector plans have been much less likely to provide full Consumer Price Indexation (CPI) of benefits after retirement than the Federal Government. Over the last ten years 46 of the Top 50 companies have provided some indexation of retirement benefits. Nearly two-thirds of the plans have given three or more increments over the ten years. During the period of high inflation toward the end of the 1970s the increments tended to occur every other year. Since 1980, with the economic slowdown and reduction in inflation the reductions have come less frequently. It should be kept in mind that during the ten year period considered here Social Security benefits were fully indexed. Thus it would be unfair to simply contract of private pension indexation to CSRS benefit indexation in comparing the effects of inflation on the respective groups of retirees.

In the consideration of a federal retirement program coordinating benefits for workers covered by Social Security, the extent of post-retirement indexation of benefits should be carefully considered. It is clear that

individuals living near subsistence should not be subject to the vagaries of inflation. The inflationary erosion of benefits in such cases can literally become a matter of life or death. At the same time, the social merit of fully indexing benefits for upper middle income beneficiaries should be weighed against the tax burden this implies for middle and lower income workers.

To a certain extent, the prevalence of secondary defined contribution plans in the private sector is a substitute for the post-retirement indexation of benefits. Meaningful benefits from these programs, however, require sustained participation by the workers in most cases. It would be worthwhile to carefully consider this structure of combined plans that is so prevalent among large private employers, and to an increasing degree, smaller ones as well. The cost of such combined benefit programs is more readily controllable than a fully indexed single benefit program.

The two particular facets of the current CSRS program that are so dissimilar to private plans, namely their relative generosity on early retirement and full post-retirement indexation, are two of the most costly facets of federal retirement. If there is any hope that the newly modified federal civilian retirement program is going to cost roughly the equivalent of large private sector retirement programs, then the current early retirement provisions and full indexation will have to be modified. This is not to say that early retirement options will have to be eliminated, nor does it mean that there would be no post-retirement benefit indexation.

Conclusion

The question of plan design is one that every employer establishing or modifying a pension plan must consider. Most employers embarking on such an endeavor look at the world around them, especially the labor market in which they function, for guidance in the development of their plan. If their total compensation package is too generous they cannot maintain their operations. If compensation is too low they cannot maintain a workforce. Similarly, if the relative distribution of compensation is heavily skewed against worker compensation and toward retirement benefits, then the ability to hire and maintain a competent workforce will be limited.

The current federal civilian retirement program appears to be out of synchronization with prevailing pension practice within the labor market in which the Federal Government must operate. Over time that will adversely affect the government's ability to hire and retain high quality workers.